

Docket: 2006-3866(IT)G

BETWEEN:

JEAN-LUC DESCHÊNES,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on October 7, 2008, at Rimouski, Quebec.

Before: The Honourable Justice Robert J. Hogan

Appearances:

Counsel for the Appellant: Marion Pelletier

Counsel for the Respondent: Christina Ham

JUDGMENT

The appeal from the assessments made under the *Income Tax Act* for the 2001, 2002 and 2003 taxation years is dismissed, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 28th day of November 2008.

“Robert J. Hogan”

Hogan J.

Translation certified true
on this 16th day of May 2009.

François Brunet, Reviser

Citation: 2008 TCC 655
Date: 20081128
Docket: 2006-3866(IT)G

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REASONS FOR JUDGMENT

Hogan J.

[1] This is an appeal from assessments for the 2001, 2002 and 2003 taxation years. The assessments are made on the basis of the net worth method. In these assessments, the Minister revised the Appellant's net business income by adding the amounts of \$54,856, \$40,544 and \$49,423 for the 2001, 2002 and 2003 taxation years, respectively. The assessment made for each of the years also includes a penalty for gross negligence imposed under subsection 163(2) of the *Income Tax Act* (the Act). The facts assumed by the Minister to make the assessments are set out at paragraphs 11 and 12 of the Reply to the Notice of Appeal which read as follows:

[TRANSLATION]

11. (a) The Appellant operated a business involving the surfacing of driveways with recycled asphalt;
- (b) The business was the Appellant's sole source of income except for the investment income amounts of \$618.13 (in 2001) and \$556.33 (in 2002);
- (c) The Appellant did not keep an account book for his business; he had no sales invoices and no purchase invoices;

- (d) Almost all of the Appellant's transactions were made in cash;
 - (e) The Appellant had accounts with the Caisse populaire de Rimouski (account no. 105718) and the Caisse populaire de Les Hauteurs (account nos. 660 and 661);
 - (f) The Appellant deposited in those accounts an amount greater than the sales amount reported;
 - (g) The Appellant began construction of his house at 855 Ste-Odile Road, Sainte-Odile-sur-Rimouski, in 2001;
 - (h) The Appellant incurred construction costs in relation to that residence in the amounts of \$57,409.36, \$43,202.78 and \$10,377.95 in 2001, 2002 and 2003, respectively;
 - (i) The Appellant also had another house located at 267 Principale Street, Les Hauteurs;
 - (j) The Appellant reported net income from his business in the amounts of \$14,543.48, \$15,290.98 and \$16,070.73 for the 2001, 2002 and 2003, taxation years, respectively;
 - (k) The Appellant told the auditor for the Canada Revenue Agency that at the end of the calendar year he would keep about \$10,000 in cash in his house to live off until the spring. According to the Appellant, when he would resume his business activities in the spring, he would use the remainder of that amount to start the activities;
 - (l) The Appellant also told the auditor for the Canada Revenue Agency that he did not receive insurance benefits during the taxation years in issue except for the amount paid to him for damages suffered in an accident involving one of his motor vehicles;
 - (m) A net worth method audit revealed that the Appellant omitted to report the business income amounts of \$54,856, \$40,544 and \$49,423 for the 2001, 2002 and 2003 taxation years, respectively (see Appendices I to III of this Reply which should be considered to be an integral part of this paragraph).
12. (a) The facts set out at paragraph 11 of this Reply;
- (b) The Appellant built his house in Sainte-Odile-sur-Rimouski during the years in issue and did not have any source of income other than the unreported income to pay for the construction work;

- (c) The income reported by the Appellant for the taxation years in issue are not congruous with the increase in his net worth and personal expenses;
- (d) The Appellant had full knowledge of his business income as he was the one who took the orders, made the bids, did the work, received the payments and made the deposits;
- (e) The Appellant knowingly, or under circumstances amounting to gross negligence, made, false statements or omissions in his tax returns for the taxation years in issue;
- (f) The amounts of unreported income involved was such that the Appellant could not have been unaware of having omitted to report the initial income amounts or having made a false statement in filing his tax returns for the taxation years in issue.

Taxation year	Reported net business income	Unreported net business income	% Adjustment
2001	\$14,543	\$54,856	377%
2002	\$15,290	\$40,544	265%
2003	\$16,070	\$49,423	308%

[2] Counsel for both parties agreed that the Respondent would open its case first. Ms. Lévesque commenced an audit of the Appellant's affairs for the taxation years in question by travelling to his principal residence situated in Rimouski. During her visit, the Appellant provided the auditor with notebooks for each of the taxation years. The notebooks were filed as Exhibit I-3. Ms. Lévesque testified that the notebooks were not kept as business records and that instead the Appellant used the notebooks to write down the names of clients, their telephone number as well as the amount estimated for the work. She noted that the Appellant did not have any other books or business records, nor did he keep copies of the invoices he prepared for his clients or his purchase invoices.

[3] Ms. Lévesque obtained directly from several banking institutions all of the Appellant's account statements. She proceeded to analyze the deposits into the Appellant's various accounts for the taxation years in question. She provided a breakdown of these accounts in Appendix 3 filed as Evidence I-2. Following her analysis of the deposits and withdrawals from the bank accounts, Ms. Lévesque noted net adjustments of \$13,657 for the 2001 taxation year, \$33,315 for the 2002 taxation year and \$46,896 for the 2003 taxation year.

[4] Following this initial observation, Ms. Lévesque testified that she decided to determine the Appellant's income for the three taxation years using the net worth method. The detailed calculations are shown in Appendices 1, 2 and 3 as Exhibit I-2. First, Ms. Lévesque prepared a balance sheet for the Appellant. She recorded the Appellant's business assets which were of the order of \$5,432, \$3,903, \$2,813 and \$2,033 for the 2000, 2001, 2002 and 2003 taxation years, respectively. For each of those years, she calculated the assets held personally by the Appellant. Among the principal assets held personally by the Appellant was a cash balance of \$10,000 which he kept in his house each year, and debit balances credited to banking institutions. Ms. Lévesque added to that the value of the Appellant's first house in Les Hauteurs close to Rimouski, as well as the cost of his second house whose construction began in 2001. Ms. Lévesque noted that the value of the Appellant's asset increased significantly between 2000 and 2003. In December 31, 2000, the value of the Appellant's asset was \$83,616. At the end of the 2003 taxation year, the value of the Appellant's asset rose to \$185,772. The main reason for the increase in the asset's value was the construction of the Appellant's house situated in Rimouski. Ms. Lévesque explained that she received from the Ministère du Revenu du Québec copies of all the invoices the Appellant submitted to obtain available credit for the construction of a new house. In total, that house cost \$112,309. The Appellant had no debts in 2000 and 2001. In 2002, he obtained, by contract, a loan of \$15,000 to build his house. At the end of the 2003 taxation year, that personal loan was reduced to \$4,123. Following this initial calculation, Ms. Lévesque noted that the Appellant's net worth had increased by \$56,359 in 2001, \$23,075 in 2002 and \$18,597 in 2003.

[5] Ms. Lévesque testified that after reviewing the bank accounts, she adjusted the Appellant's net worth appearing in Appendix 1 as Exhibit I-2 so as to add net adjustments resulting from the analysis of the bank deposits. For the 2001 taxation year, the net adjustment was \$13,657. For the 2002 taxation year, the net adjustment was \$33,315. Finally, for the 2003 taxation year, the net adjustment was \$46,896. This last calculation allowed Ms. Lévesque to complete Appendix III which establishes the amount of the Appellant's unreported net business income shown in the third column of paragraph 12(f) of the Reply to the Notice of Appeal.

[6] Ms. Lévesque met with the Appellant at the offices of the Canada Revenue Agency (CRA) to show him the calculations indicated as Exhibit I-2. She asked the Appellant if he had other invoices that he omitted to give to her. He did not provide Ms. Lévesque with details about other expenses.

[7] According to Ms. Lévesque, it was the considerable gaps determined by the net worth method between the net income reported by the Appellant and the

unreported income detected by Ms. Lévesque that prompted her to assess a penalty under subsection 163(2) of the *Income Tax Act* (the Act).

[8] The Appellant testified in his case. At first, he explained that he was native of Les Hauteurs close to Rimouski. He testified that he left school very early, that is to say, after his fifth year, and that at age 14 he worked with his father on the family farm. He held that job for six to seven years.

[9] Subsequently, he worked at a garage in Les Hauteurs until the age of 20.

[10] He got married in 1968 and had his first child in 1969. He had a second child in 1970. When he left Les Hauteurs, he held a job as a custodian at a hunting and fishing club. He and his children lived with his employer until his youngest child was fourteen years old.

[11] He returned to Les Hauteurs to work for the municipality. At the time, his youngest child started school.

[12] With the help of one his brothers, he built his first house in Les Hauteurs in which he lived for many years and which he eventually sold for \$40,000 after the period in question.

[13] He explained to the Court that in about 1974 he worked as a porose operator in James Bay. He testified that he held that job for seven and a half to eight years, from 1975 to 1982. He would work each year for a period of seven to eight months after which he would go back to Les Hauteurs. He stated that that job allowed him to accumulate a nest egg of about \$55,000 to \$80,000.

[14] In about 1982, the Appellant returned to Les Hauteurs where he worked for two to three years in the construction industry. He testified that in 1982 he came up with the idea to recycle asphalt derived from road maintenance works in Les Hauteurs to pave his driveway. To that end, he built a home-made boiler to which he added a propane flamer. He reheated the recycled asphalt to melt it and used the melted asphalt to pave his driveway. That is how his business was born.

[15] The news travelled by word of mouth and the neighbours in Les Hauteurs asked him if he could use the recycled asphalt to pave their driveway. Toward the end of that year, he had a visit from a citizen of Rimouski who asked him if he could pave the driveway at his house which was located in the neighbouring city.

[16] The Appellant explained to the Court that he worked alone in his own business. As his business grew, the purchaser acquired used equipment, including a truck, a roller and a loader. He also built a larger boiler that could hold larger quantities of recycled asphalt.

[17] He testified that he worked in collaboration with one Mr. Banville. Mr. Banville would prepare the driveway when necessary to allow the Appellant to then proceed with the laying of the asphalt.

[18] He explained that it was possible for him to work between June 15 and September 15, but only if the weather permitted. In 2001, he commenced construction of his current principal residence. He testified that, first, he cut his wood which was then sawn. The construction period lasted from 2001 to 2003.

[19] He testified that the amount of cash he kept in his house had increased since the time he worked in James Bay. The amount increased to approximately \$138,000. At his first meeting with the auditor at his house and when he met with her at the CRA's offices, he admitted to having omitted to mention to the auditor that he kept that substantial amount of cash in his house at the beginning of 2001.

[20] After his meeting at the auditor's office in Rimouski, the Appellant testified that his accountant told him that he should consult a tax expert. He met with a tax expert and explained his situation to her. The tax expert apparently told him that he should have mentioned to the auditor that he kept that substantial amount of money in his house which he used to build his principal residence from 2001 to 2003.

[21] The Appellant was asked a number of questions on cross-examination. The Court asked him to explain the events surrounding his divorce from his first wife in 1992. In answering those questions, he admitted that his first wife knew that in 1992 he kept about \$80,000 in cash in his house.

[22] The Court asked him if his first wife asked him to divide that money during the divorce proceedings. He answered "no." His wife was said to have rather accepted his offer to pay her half of the value of his first house located in Les Hauteurs. According to a notarial deed, filed as Exhibit I-1, that house was only sold in 2004 for \$40,000. According to the Appellant, it was not until that time that he paid his first wife one-half of the proceeds from the sale of the house.

[23] Later, the Appellant said that he lived in Rimouski with his second wife with whom he had a third child. He stated that his second wife threatened to sue him for

support payments for their daughter born of the common-law marriage. He did not tell the Court whether she knew that he kept a substantial amount of cash in his house or if she knew where the funds used to build his house came from.

[24] The Appellant admitted that the only loan he took out to build his house was for a sum of about \$15,000 which he obtained from the caisse populaire.

[25] On cross-examination, counsel for the Respondent showed the Appellant the notebooks in which the Appellant entered bids. Since counsel for the Appellant did not consider it advisable to tender those documents in evidence during the examination-in-chief, counsel for the Respondent decided to do so. The notebooks were filed in the Court record as Exhibit I-3.

[26] The Court could tell that the notebooks were far from being clear. There were circled telephone numbers, names, as well as, on certain pages, the Appellant's address and an estimate for the Appellant's work. The margin of certain pages contained a record of hours. The Court asked the Appellant to explain what those notes meant. The Appellant explained that those notes sometimes indicated the number of hours spent with his clients. The Court must note that, considering the state of the notebooks in question, it was impossible for the auditor to draw any conclusions except that the Appellant did not meet his duty to keep accounting records that could have enabled the auditor to verify the gross income and expenses of the Appellant's business.

[27] Counsel for the Appellant did not deem it advisable to offer in evidence any other accounting document or income and expense reconciliation statement for the years in question.

Analysis

[28] Counsel for the Appellant essentially raised two issues to challenge the Respondent's assessment.

[29] First, he argued that it was unlikely that the Appellant could have earned a net income corresponding to that established by the CRA. He submitted that the Appellant's testimony demonstrated that the Appellant always worked alone and that it would have been impossible for him to earn such a high gross income during the short summer period.

[30] Then, he argued that the CRA auditor could have established the Appellant's net income using the notebooks. He noted that the auditor did not deem it advisable to use that methodology and did not ask the Appellant any questions to help him in that regard.

[31] Finally, counsel for the Respondent took note of the fact that it took the Appellant many years to accumulate a significant amount of cash that he kept in his house with a view to fulfilling his dream of building a house in Rimouski.

[32] Counsel for the Appellant noted that the Appellant co-operated with the auditor during their meetings and that he did not dispose of his property to evade recovery proceedings by the Minister. In that regard, he pointed out to the Court that both the CRA and the Ministère du Revenu du Québec registered a legal hypothec on the Appellant's principal residence. The Appellant did not object to the registration of the legal hypothecs. That conduct revealed a willingness to co-operate with the authorities and not an attempt to shirk his obligations. He recognized that the Appellant failed to meet his duty to keep accounting records, but, given the low level of schooling he had, that was understandable under the circumstances.

[33] As for the penalty, counsel for the Appellant noted that his client always co-operated with the CRA during the audit.

[34] The Court is of the view that the Appellant failed to meet his duty to keep proper accounting records that could have allowed the CRA to verify the Appellant's net income without having to proceed by way of the net worth method. First, the Court notes that the notebooks were unintelligible to a third party such as the auditor. It is not the CRA's responsibility to try to reconstruct a taxpayer's net income from improper documentation.

[35] In addition, the Court is of the view that the Appellant could have tried, with the help of a tax expert, to redo the Appellant's financial statements, which could have perhaps helped the Court understand the evolution of the Appellant's net income during the period in question. The Appellant and his counsel did not deem it advisable to seek the services of an accountant or a tax expert for that purpose.

[36] Moreover, the Court notes that the Appellant did not prepare any invoices for his clients. At least the Appellant did not file any exhibits with the Court. In a self-assessment system, the onus is on taxpayers to do the bookkeeping, which, at a minimum, could enable the CRA to conduct its audit.

[37] The Court finds the Appellant's testimony that he kept a significant amount of money in his house for many years implausible. It is unlikely that in the course of the divorce proceedings in 1992, his ex-wife neglected to make a request for the division of that asset and waited many years only to receive one-half of the proceeds from the sale of the house in Les Hauteurs which took place in 2004. If she did not seek the division of that considerable asset, it is because the Appellant did not accumulate the funds, contrary to what he testified in chief. Moreover, if the Appellant had accumulated funds after holding a job in James Bay in respect of which he reported the net income to the auditor, why would he have kept those funds in his house and risk having them stolen or losing them in a fire? The Appellant claimed that he kept the funds in a can. The funds did not enjoy any form of protection. Finally, the funds did not generate any interest for the Appellant.

[38] I note the following findings of Tardif J. in *Ruest v. Canada*, [1999] T.C.J. No. 586 (QL):

27 Since the assessments resulted from the observed discrepancy between income and expenses relative to capital or assets, the burden was solely on the appellant to explain that discrepancy. To convince the Court, he had to show on the balance of evidence that his claims were plausible, reasonable, correct and coherent. It was not enough to criticize and raise certain minor grievances in order to enable the Court to conclude that everything balanced as a result of the amount received at a particular moment.

28 This, I agree, might have required a colossal amount of work, but it should nevertheless be pointed out that a taxpayer assessed by means of the net worth method is himself responsible for the manner in which he has been assessed in that he deliberately and knowingly chose not to have any accounting system and to keep no record of his income and expenses.

[39] I find that the evidence adduced by the Appellant, with respect to his submission that he accumulated considerable savings over the course of the previous years, to explain the gap of over \$104,000 determined by the auditor for the 2001, 2002 and 2003 taxation years, is insufficient to establish on a balance of probabilities that the assessments in which a portion of that amount was added to the income of each of those years are incorrect.

[40] The gap between the reported net business income and the unreported business income is very significant. For 2001, the unreported income is equivalent to 377% of the reported income. For 2002, the unreported income is equivalent to 265% of the reported income. Finally, for 2003, the unreported income is equivalent to 308% of the reported income. The Court finds that the Respondent discharged the onus of

proof imposed on the Respondent under subsection 162(3) as the Appellant knew or should have known that the reported net income represented only 25% to 33% of the business income earned during each of the years in question. In that regard, I follow these comments of Pelletier J.A. of the Federal Court of Appeal in *Lacroix v. Canada*, 2008 FCA 241:

30 The facts in evidence in this case are such that the taxpayer's tax return made a misrepresentation of facts, and the only explanation offered by the taxpayer was found not to be credible. Clearly, there must be some other explanation for this income. It must therefore be concluded that the taxpayer had an unreported source of income, was aware of this source and refused to disclose it, since the explanations he gave were found not to be credible. In my view, given such circumstances, one must come to the inevitable conclusion that the false tax return was filed knowingly, or under circumstances amounting to gross negligence. This justifies not only a penalty, but also a reassessment beyond the statutory period.

...

32 . . . Insofar as the Tax Court of Canada is satisfied that the taxpayer earned unreported income and did not provide a credible explanation for the discrepancy between his or her reported income and his or her net worth, the Minister has discharged the burden of proof on him within the meaning of subparagraph 152(4)(a)(i) and subsection 162(3).

[41] For all these reasons, I dismiss the appeal for the 2001, 2002 and 2003 taxation years.

Signed at Ottawa, Canada, this 28th day of November 2008.

“Robert J. Hogan”

Hogan J.

Translation certified true
on this 16th day of May 2009.

François Brunet, Reviser

CITATION: 2008 TCC 655

COURT FILE NO.: 2006-3866(IT)G

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MAJESTY THE QUEEN

PLACE OF HEARING: Rimouski, Quebec

DATE OF HEARING: October 7, 2008

REASONS FOR JUDGMENT BY: The Honourable Justice Robert J. Hogan

DATE OF JUDGMENT: November 28, 2008

APPEARANCES:

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